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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

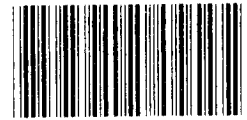
Serious Problems Need To Be Corrected Before Federal Merit Pay Goes Into Effect

By October 1, 1981, pay increases for Government managers and supervisors in grades GS-13 through GS-15 are to be based on performance. Approximately 100 agencies will be required to implement merit pay systems to compensate as many as 152,000 employees.

However, OPM's decentralized, nonprescriptive approach has not provided the leadership agencies need to insure quality merit pay programs. As a result, agencies are experiencing problems that will ultimately affect the merit pay program. Many agencies are not pretesting their systems to identify and correct problems early.

OPM's method for computing agencies' merit pay funds will cost the Government from \$58 to \$74 million more each year than if employees had remained under the General Schedule pay system. Furthermore, OPM's merit pay formula permits funds that cannot be paid to employees at the \$50,112.50 statutory pay ceiling to be paid to employees below the ceiling. The increase in payroll costs and the use of "capped money" for merit pay employees do not conform with the Civil Service Reform Act.

GAO recommends delaying merit pay implementation until agencies are ready to make sound pay decisions based on performance and urges OPM to revise its formula to comply with the law.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report was prepared in response to a request from the Chair, Subcommittee on Compensation and Employee Benefits, House Committee on Post Office and Civil Service. It points out that problems with merit pay implementation could cause program failure unless immediate action is taken. These problems were identified earlier when GAO testified before the Subcommittee on July 21, 1981. As a result of the merit pay hearings, the Subcommittee requested that the President of the United States take action to prevent Federal agencies from implementing faulty pay-for-performance systems. The actions requested by the Subcommittee are similar to the recommendations contained in this report.

We are sending copies of this report to the President of the United States; the Chair, Subcommittee on Compensation and Employee Benefits, House Committee on Post Office and Civil Service; the Director, Office of Management and Budget; the Director, Office of Personnel Management; and other interested parties.

Milton J. Fowler
Acting Comptroller General
of the United States



D I G E S T

At the request of the Chair, Subcommittee on Compensation and Employee Benefits, House Committee on Post Office and Civil Service, GAO reviewed Federal agencies' progress in implementing the performance appraisal and merit pay provisions of the Civil Service Reform Act of 1978. This report points out that problems with merit pay implementation could cause program failure unless immediate action is taken. These problems were surfaced earlier when GAO testified before the Subcommittee on July 21, 1981. As a result of the hearings, the Subcommittee wrote the President requesting that action be taken similar to the recommendations contained in this report.

Under the Reform Act, pay increases for management officials and supervisors in grades GS-13 through GS-15 are, as of October 1, 1981, to be based on their performance. The Office of Personnel Management (OPM) estimates that approximately 100 agencies will be required to implement merit pay systems. These systems will be used to compensate as many as 152,000 employees. As the October 1 deadline nears, GAO is concerned about agencies' readiness to make sound merit pay decisions.

Performance appraisal experts in private industry say good performance appraisal systems take 3 to 5 years to develop, with extensive pretesting and evaluation. Federal agencies were given only 2 years to develop their systems, and many will not have pretested or evaluated their systems by October 1. Officials at several agencies that have pretested believe more work is needed before sound pay decisions can be made.

With pay decisions affecting so many Federal managers, the Government has a responsibility to insure that sound, pretested merit pay systems are in place before pay decisions are made. GAO supports the merit pay concept but believes implementation problems could cause the system to lose credibility and the program to fail.

OPM NEEDS TO TAKE A MORE
AGGRESSIVE LEADERSHIP ROLE

The Reform Act gave OPM the responsibility to implement the merit pay program. This responsibility covers a broad range of activities, from developing policy to insuring agency compliance with civil service rules and regulations. In fulfilling these duties, OPM has taken what it terms a decentralized and nonprescriptive approach to give agencies considerable flexibility in designing their own systems. However, OPM is not providing the leadership needed to insure quality merit pay programs.

OPM's nonprescriptive approach has resulted in guidelines to agencies that are not timely or definitive enough to insure that effective pay-for-performance systems will be developed.

For example:

- OPM's General Counsel issued an opinion in January 1981 concerning the definition of performance levels. OPM told agencies making merit payouts that they may choose to comply with this new instruction in 1981 or wait until fiscal year 1982 to comply; however, OPM also warned these agencies that, technically, their systems are not conforming with OPM guidelines, leaving agencies open to employee lawsuits. (See pp. 7 and 8.)
- Several officials in the agencies we visited that made payouts in 1980 stated that the merit pay coverage guidelines provided by OPM were general and allowed them considerable leeway in deciding whom to include in merit pay. Representatives in 10 of the 15 agencies GAO reviewed, which were preparing for 1981 payouts, believed OPM's guidelines were inadequate. As a result, some employees who are not actually management officials may be included in merit pay and some that are management officials may not be included. (See pp. 8 and 9.)

OPM's current priority is to insure that all agencies meet the October 1, 1981, deadline for merit pay determinations. Its emphasis has

been on reviewing and approving agencies' performance appraisal and merit pay plans for compliance with the law, and not on assessing the quality of these systems or assuring that they operate properly. (See pp. 4 and 10.)

PROBLEMS WITH PERFORMANCE APPRAISALS
THREATEN SUCCESS OF MERIT PAY

Sound performance appraisal systems are crucial to the successful implementation of the Federal merit pay program. In response to a Merit Systems Protection Board questionnaire, merit pay employees in the agencies that made payouts in October 1980 indicated that when performance appraisals were fair, merit pay distributions would be fair, and that good or improved performance would be encouraged as a result. Unfortunately, where performance appraisal problems exist and appraisals are not viewed as being fair, the opposite of this is probably true.

Eight agencies implemented merit pay programs in October 1980. After reviewing the performance appraisal and merit pay systems of 6 agencies and determining the status of implementation in 15 agencies preparing to pay out in 1981, GAO found several performance appraisal problems:

- Four of the six agencies did not completely and adequately pretest their appraisal systems before making merit pay determinations. Some agencies had problems which affected the integrity of their pay-for-performance programs. Eight of the 15 agencies that are preparing to pay out in 1981 will not have fully pretested their systems. (See pp. 13 and 14.)
- Each of the six agencies experienced difficulty with setting performance standards. Lack of employee participation and the use of overly quantitative standards (with limited emphasis on qualitative measures) were typical problems. (See pp. 15 and 16.)
- Management officials responsible for reviewing performance appraisals at two agencies used arbitrary and subjective criteria rather than preestablished performance standards to make

changes to appraisals. This has resulted in numerous employee grievances. (See pp. 16 and 17.)

--OPM has not set a required time limit for an adequate appraisal period. Several of the 15 agencies will have performance standards in place for appraisal periods of less than 1 year. Two agencies will have standards in place for less than 90 days. (See p. 16.)

MERIT PAY FORMULA INCREASES GOVERNMENT COST

OPM's method for computing agencies' merit pay funds will cause the Government to spend from \$58 to \$74 million more each year than it would have if employees had remained under the General Schedule pay system. At the three largest agencies implementing merit pay in October 1980, payroll costs for around 1,850 merit pay employees were approximately \$1 million, or 1.2 percent, more than they would have been under the General Schedule. This increase represented 23 percent of the total merit pay funds expended.

Furthermore, OPM's merit pay computation formula permits funds that cannot be paid to employees at the \$50,112.50 statutory pay ceiling to be paid to employees below the ceiling. The increase in payroll costs and the use of "capped money" for merit pay employees do not conform with the provisions of the Reform Act. GAO has issued a Decision of the Comptroller General addressing problems with the merit pay funding formula. (See pp. 20 to 23 and app. VI.)

RECOMMENDATIONS TO THE DIRECTOR, OPM

GAO recommends that the Director, OPM:

- Require agencies to pretest their entire pay-for-performance systems, from standard-setting to appraisal and merit payouts, before making actual payouts.
- Require all agencies to comply with OPM guidelines on defining levels of performance before making payouts.

- Petition the President to grant exclusions from the October 1981 merit pay deadline to those agencies that have not pretested their entire performance appraisal and merit pay systems and those agencies that do not comply with OPM guidelines.
- Certify, after reviewing an agency's pretest, that the agency does fairly and accurately link pay to performance.
- Require agencies to insure employee participation in developing performance standards that address the most important elements of the employee's job in both qualitative and quantitative terms.
- Insure that agencies use performance standards that have been agreed to by the supervisor and employee at the beginning of the appraisal period as the basis for performance evaluations as mandated by the Reform Act. Require those managers responsible for reviewing performance appraisals to also review and approve performance standards early in the appraisal period.
- Require agencies to have performance standards in place at least 120 days before making pay decisions based on those standards.
- More clearly define which employees are to be included in the merit pay program.

The Reform Act restricts the amount available for merit pay to the amount which would have been spent under the previous pay system. Therefore, we are urging that OPM:

- Revise its merit pay computation formula to insure that payroll costs under merit pay do not exceed what would have been paid had the General Schedule pay system remained in place for merit pay employees.
- Develop a 1981 merit pay computation formula for those agencies that have already made payouts to adjust for the additional funds used in 1980.

--Insure that merit pay funds attributable to employees at the \$50,112.50 ceiling are not used to reward employees below the ceiling.

RECOMMENDATION TO THE PRESIDENT

GAO recommends that the President, based on OPM's petition, exclude from the October 1981 mandatory merit pay implementation date those agencies that have not pretested their entire performance appraisal and merit pay systems and those agencies whose systems do not comply with OPM's guidelines and General Counsel opinion. This will enable OPM to require agencies to pretest their entire pay-for-performance systems before making actual merit payouts and to give agencies time to make their performance appraisal systems comply with OPM guidelines and the General Counsel opinion.

RECOMMENDATION TO THE CONGRESS

If the October 1981 mandatory merit pay implementation deadline is not delayed, GAO recommends the Congress enact an appropriation restriction in a fiscal year 1982 appropriations act. This restriction would prohibit agencies from making merit payouts beginning in October 1981 if they have not pretested their entire performance appraisal and merit pay systems or complied with OPM guidelines.

The following or similar language should be incorporated in a fiscal year 1982 appropriations act:

"No part of any appropriation contained in this or any other Act, or the funds available for expenditures by any agency, shall be used to fund an agency's merit pay program unless that agency has pretested its entire performance appraisal and merit pay system and is in compliance with OPM's merit pay program guidelines."

AGENCY COMMENTS

At the direction of the Subcommittee, we did not obtain agency comments on this report.

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ABBREVIATIONS

EPA	Environmental Protection Agency
FLRA	Federal Labor Relations Authority
FPM	Federal Personnel Manual
GAO	General Accounting Office
MSPB	Merit Systems Protection Board
OPM	Office of Personnel Management
SBA	Small Business Administration.

CHAPTER 1

INTRODUCTION

At the request of the Chair, Subcommittee on Compensation and Employee Benefits, House Committee on Post Office and Civil Service (see app. I) and, in accordance with 5 U.S.C. 4304 1/, we reviewed Federal agencies' progress in implementing the performance appraisal and merit pay provisions of the Civil Service Reform Act of 1978. The Subcommittee was interested in agencies' progress in implementing these provisions and in insuring that agencies were designing and implementing systems which would objectively assess performance and result in sound pay determinations.

The information discussed in this report was presented in testimony at merit pay hearings held by the Subcommittee on July 21, 1981. As a result of these hearings, the Subcommittee wrote the President on August 13, 1981, requesting immediate action be taken regarding the implementation of pay-for-performance systems. These actions correspond with our testimony and the recommendations contained in this report.

BACKGROUND

Under the Reform Act, pay increases for supervisors and management officials in grades GS-13 through GS-15 of the General Schedule are to be based on performance. This provision represents a major change in agencies' personnel procedures in at least two basic areas. First, performance appraisals for merit pay employees must be based on preestablished performance standards and conducted much more rigorously than had been the case before the Reform Act. Second, merit pay employees are no longer guaranteed full comparability adjustments and are no longer eligible for within-grade or quality-step increases. (See app. II.) Instead, they must earn these increases on the basis of their job performance.

The Office of Personnel Management (OPM) has responsibility for developing procedures to implement the new pay-for-performance system Government-wide. To date, OPM has taken a decentralized approach to implementation, allowing agencies to design systems on their own within general OPM guidelines. OPM provides technical

1/The Civil Service Reform Act of 1978 (Public Law 95-454) mandates GAO to review, on a selected basis, performance appraisal systems to determine whether these systems meet the requirements of the act. Results of these reviews are to be reported, periodically, to the Office of Personnel Management and the Congress.

assistance to agencies in developing their programs, reviews and approves performance appraisal and merit pay plans, and is developing an information system to evaluate implementation.

Approximately 100 agencies in the Federal Government are included in the merit pay program. Of about 195,000 employees in grades GS-13 through GS-15, between 120,000 and 152,000 employees considered to be supervisory or management officials will be included in the program. ^{1/} Individual agencies decide who should be covered, according to OPM's guidelines.

The Reform Act requires the merit pay provisions to be implemented on the first day of the first applicable pay period beginning on or after October 1, 1981. Thus, performance appraisal systems would have to be in place for some time before the October 1 deadline. Agencies, with OPM approval, were allowed to go forward with merit pay 1 year earlier (October 1, 1980). Eight small agencies representing about 2,200 merit pay employees did so and made payouts effective October 1980. (See app. III.)

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to evaluate the experiences of agencies that made merit payouts effective October 1980, assess the preparedness of selected agencies scheduled to make payouts in October 1981, and evaluate the adequacy of OPM's technical assistance and guidelines. Specifically, we reviewed:

- OPM's effectiveness in discharging its performance appraisal and merit pay responsibilities under the Reform Act.
- Agencies' progress in establishing the required appraisal and merit pay systems.
- The October 1980 payouts made by selected Federal agencies.
- The status of implementation in certain Federal agencies preparing to pay out in 1981.

Our review covered agencies' implementation efforts during the period October 1979 to May 1981. We interviewed officials

^{1/}The Reform Act states that agency merit pay programs are to cover all GS-13 through GS-15 employees whose duties meet the definition of supervisor or management official as stated in 5 U.S.C. 7103.

responsible for the implementation of merit pay at OPM and in six 1/ of the eight agencies which made payouts in 1980. (See app. III.) Two of the eight agencies had only a very small number of merit pay employees and, therefore, were not included in our review. We interviewed in both field and headquarters offices. We also reviewed OPM guidelines and regulations, agencies' performance appraisal and merit pay system plans, selected performance agreements and appraisals, agency operating procedures, and employee grievances.

To assess the readiness of agencies planning to make initial payouts in October 1981, we interviewed officials at 15 large agencies. (See app. IV.) These agencies were chosen because they represent as many as half of all employees due to be affected by the full implementation of merit pay in October 1981 (depending on the total number of employees converted to merit pay).

We also reviewed OPM's formula for computing merit pay funds. Additionally, by using payroll information on all merit pay employees in the three largest agencies that made payouts in 1980, we computed the salary expenditure (excluding promotions) that would have occurred had the employees remained under the General Schedule. We then compared this information to the increases received under merit pay.

To assess the attitudes and experiences of mid-level Federal employees in merit pay, we used data from a survey initiated and conducted by the U.S. Merit Systems Protection Board (MSPB). This survey collected information on employees' attitudes and experiences regarding the performance appraisal and merit pay systems in their agencies. For our review, we used MSPB survey data dealing exclusively with the eight agencies making merit payouts in 1980. (See app. V.) The survey results provided the best available data on how the merit pay experience was viewed by these employees. We were not involved in the questionnaire design.

At the direction of the Subcommittee, we did not obtain agency comments on this report.

1/In addition to having overall responsibility for merit pay, OPM is also one of the six agencies we reviewed that made merit payouts in 1980.

CHAPTER 2

OPM NEEDS TO TAKE MORE RESPONSIBILITY FOR THE SUCCESS OF PERFORMANCE APPRAISALS AND MERIT PAY

OPM needs to take a more aggressive management role to insure that quality pay-for-performance programs are implemented. OPM's current priority is to insure that all agencies meet the October 1, 1981, deadline for merit pay determinations. Consequently, its emphasis has been on approving agencies' performance appraisal and merit pay plans rather than on assessing the quality of these systems and assuring that they are being operated as designed. OPM has not emphasized assessing the quality of the performance standards or the ability of these agencies' systems to make accurate and fair pay-for-performance decisions.

Furthermore, OPM officials have stated publicly that they expect the initial quality of the performance appraisal and merit pay systems will be poor and even anticipate some will fail. They believe, however, this should be expected when implementing a program of such magnitude.

OPM's emphasis on meeting the October 1981 deadline, regardless of system quality, raises serious questions about the merit pay program's chance for success. Furthermore, OPM's lack of aggressive and timely leadership has resulted in

- untimely or inadequate assistance for Federal agencies;
- late, confusing, and everchanging policy guidelines and regulations; and
- limited evaluation of system quality.

Problems experienced by the initial agencies and the rest of the Government agencies we reviewed indicate that OPM must provide more and better leadership before further merit payouts are made.

OPM NEEDS TO TAKE MORE RESPONSIBILITY FOR PAY-FOR-PERFORMANCE PROGRAM

OPM was given responsibility for both performance appraisal and merit pay implementation by the Civil Service Reform Act of 1978. According to the act, OPM must prescribe regulations for both systems. OPM must review and approve agency performance appraisal and merit pay plans for compliance with the law and OPM regulations. It must also provide technical assistance to agencies, calculate the funds available for merit pay adjustments, and report annually on the cost and effectiveness of the merit pay program.

In fulfilling its legal responsibilities, OPM has taken a decentralized, nonprescriptive approach and given agencies considerable flexibility to design their own programs. OPM program divisions provide agencies policy guidelines and technical assistance, as well as model systems, examples of performance standards, and simulations of merit payouts. They also review and approve agencies' performance appraisal and merit pay plans to insure that all required elements are included, such as performance standards, appraisal mechanisms, merit pay fund calculations, system coverage criteria, the link between performance appraisal and personnel decisions, and an evaluation plan.

While OPM has taken some steps to assist in implementing the merit pay program, we recommended in our earlier report 1/ that OPM take a more active management role in the process.

Our report contained five recommendations aimed at minimizing potential problems. We recommended that OPM:

- Establish minimum pretest criteria for agencies to meet before making initial merit pay determinations. OPM acknowledged the need for thorough pretesting of both the performance appraisal and merit pay plans in all agencies, but has not required agencies to do so. Consequently, some Federal agencies will be allowed to implement merit pay in October 1981 without having pretested their systems.
- Take a stronger role in encouraging agencies to develop additional training courses and other programs designed to increase managerial skills and gain employee acceptance of pay-for-performance systems. OPM agreed with us on the importance of adequate training for merit pay employees and stated that it would "actively pursue any training needs and help develop and encourage the use of training in the agencies." However, it did not mention any specific steps it was taking to further performance appraisal and merit pay training; stating only that, to date, "OPM has provided adequate and appropriate assistance."
- Require agencies to define the objectives of their merit pay systems more specifically and develop evaluation strategies, using these objectives, to monitor operations of the merit pay plans. OPM stated that "the objectives and goals of an agency should be determined as part of

1/"Federal Merit Pay: Important Concerns Need Attention," (FPCD-81-9, Mar. 3, 1981).

a larger work planning and budgetary process and reflected in the performance standards and elements of higher level management." Regarding evaluation, OPM stated that it "will monitor and determine if agencies can and have developed workable systems which provide meaningful differences in pay based solely on performance." Again, however, OPM did not outline in specific terms how or if it planned to implement our recommendations.

- Provide more detailed cost information to the Congress on the implementation of the merit pay program. On this point OPM was specific, stating that it would issue, by June 1981, "guidance to the agencies on the collection of merit pay implementation cost data." As of August 11, 1981, OPM had not issued guidelines on this subject.
- Issue more detailed guidelines on coverage so that agency heads and employee associations will have a clearer idea of those employees that should or should not be covered by merit pay. OPM responded that it has petitioned the Federal Labor Relations Authority (FLRA) for some key coverage interpretations, and until FLRA makes a decision on that petition, will stand on its earlier guidelines augmented by ongoing discussions with agency representatives.

We believe immediate action is needed to correct these problems.

TECHNICAL ASSISTANCE NOT TIMELY
OR ADEQUATE FOR FEDERAL AGENCIES

OPM's performance appraisal and merit pay groups were experiencing staffing shortages during the early implementation of merit pay. While agencies were developing and implementing their merit pay programs, each group had only four or five people to provide technical assistance to over 100 agencies. Because of this staffing shortage and the heavy workload associated with starting these major programs, most agencies received little help. OPM concentrated its efforts on those agencies having serious design problems.

During the time that the eight agencies were developing and implementing their systems for payouts in October 1980, OPM was just beginning to provide guidelines and technical assistance on performance appraisal and merit pay systems. According to agency officials, this caused several problems because the agencies were implementing their systems before OPM had issued regulations or guidelines. Agencies were asking for guidelines that had not been formulated or had not even been considered by OPM.

Officials in the agencies that made payouts last October believed they provided on-the-job training for OPM's technical assistance staffs. Several agency officials stated that OPM staff could not answer many of their questions, so they had to wait for OPM to research the answer or do the research themselves. One agency even helped OPM design a training course for other agencies. Many agency officials believed that OPM's lack of experience caused agencies to solve similar problems without the benefit of knowing what solutions other agencies had found. Several officials also stated that they would have been better served if OPM had done some background work before it tried to help the agencies.

OPM's performance appraisal and merit pay groups have since increased their staffing levels. This has allowed some agencies to receive more help when they ask for it. However, assistance is provided only when agencies request it and on a first-come, first-served basis. For example, in a December 1980 survey assessing the status of performance appraisal implementation, the OPM Agency Relations Group identified several problems in agencies, such as the need for guidelines in evaluating systems and training, and assistance in standards development. Such problems could seriously hamper the successful implementation of performance appraisals and thus the merit pay initiatives. Although OPM is aware that these problems exist, it has initiated no actions to solve them.

OPM'S NONPRESCRIPTIVE APPROACH HAS
RESULTED IN LATE, INADEQUATE, AND
CONFUSING GUIDELINES TO AGENCIES

Although OPM has the responsibility to prescribe regulations implementing a merit pay program, its nonprescriptive approach has resulted in guidelines that are not timely or definitive enough to insure that effective pay-for-performance systems will be developed. OPM issued some regulations so late that many agencies' previously approved plans are now out of compliance. OPM has also used informal, unwritten guidelines in some areas where more prescriptive guidelines are needed. These shortcomings have caused serious problems for many Federal agencies.

OPM'S General Counsel opinion
could seriously affect 1981 payout

In January 1981, OPM's General Counsel issued an opinion stating that agencies could not project a performance rating more than one level above or below a defined standard. According to OPM, for example:

"* * * an agency may require its employees to process 10 documents per hour for fully successful performance.

Based on this standard, it can accurately determine that an employee who processes less than 10 documents is performing below the fully successful level and that an employee who processes above 10 documents is performing above the fully successful level. Absent any additional standard the agency would have no way of demonstrating that processing less than 10 documents is unacceptable rather than minimally acceptable performance or that processing more than 10 documents is performance which exceeds fully successful rather than that which is outstanding. Thus, an agency would be unable to defend either its performance appraisal system or any actions taken on the basis of such a rating."

OPM officials stated this idea had been considered for almost a year before the formal opinion was written. A Federal Personnel Manual (FPM) letter was issued in March 1981 to reflect this new criteria. Thirty-three agencies whose plans had been approved by OPM, including three that had already made payouts, are now considered to be out of compliance with the new FPM letter. According to OPM, however, agencies making merit payouts effective October 1, 1981, may choose to comply with this new regulation in 1981 or wait until fiscal year 1982 to comply. While this could relieve the problem of having to redefine standards in the middle of an appraisal period for those agencies choosing to postpone compliance, it causes another potentially serious problem for these agencies. OPM has warned agencies choosing postponement that technically their systems do not comply with OPM regulations and the agencies could be open to lawsuits from employees who wish to contest any personnel decisions made as a result of their performance appraisals.

Ten of the 15 agencies whose systems we reviewed that are preparing to pay out in 1981 are included in the 33 agencies now out of compliance. Of these, some agencies reported that they believed they had to comply; others were not sure. All of the 10 agencies expressed concern at having to redefine standards at this late date, since this would necessitate starting a new performance appraisal period with so little time left before the October 1 deadline. Several agencies will be out of compliance with the regulation when they pay out in October 1981.

Merit pay coverage guidelines are unclear

As we noted in our earlier report 1/ on merit pay implementation, concerns have emerged as to which GS-13 through GS-15

1/"Federal Merit Pay: Important Concerns Need Attention," (FPCD-81-9, Mar. 3, 1981).

employees should be included in the merit pay program. The Reform Act states that supervisors and management officials in grades GS-13, 14, and 15 are to be included. However, several officials in the agencies we visited that made payouts in 1980 agreed that the coverage guidelines provided by OPM were general and allowed them considerable leeway in deciding whom to include in merit pay. As a result of this latitude, some employees who are not actually management officials may be included in merit pay, and some who are management officials may not be included.

OPM has not issued additional guidelines because it believes there has been an " * * * absence of any substantial and informative decisions by the Federal Labor Relations Authority (FLRA) on the application of the definition of management official * * *" for merit pay purposes. OPM and five other agencies have petitioned FLRA for interpretations of the definition of "management official." OPM has indicated that it will not issue additional guidelines until the FLRA makes a decision on the petition.

Many of the officials we spoke to in the 15 agencies preparing for 1981 payouts were particularly critical of the merit pay coverage guidelines. Representatives in 10 of the 15 agencies believed these guidelines were inadequate. Most of the problems seemed to center on the definition of a "management official" and the determination of whether employees in specific jobs play a policymaking role requiring a great deal of judgment. Most agency officials believed that coverage should be expanded to all GS-13 through GS-15 employees to eliminate these problems.

Formal OPM regulations are
lacking in key areas

Consistent with its nonprescriptive role, OPM has provided agencies with informal recommendations rather than formal regulations in several key areas of pay-for-performance development. This lack of explicit direction has contributed to the problems agencies experienced in the first year of merit pay. For example, OPM has not required agencies to:

- Pretest their entire pay-for-performance systems. As a result, many agencies chose not to pretest. The lack of pretesting could lead to problems and reduced credibility for their systems.
- Review performance standards to insure they are measurable, objective, and fair. A number of employees in the agencies making payouts in 1980 did not believe their standards were rational.
- Establish a minimum time frame for performance appraisal standards to be in effect. Appraisal periods vary from

90 days to 1 year. OPM suggests that it would be "useful" for appraisal periods to be 1 year in length and recommends 120 days as the minimum amount of time in which a supervisor can make an objective appraisal.

Agencies are also concerned about OPM's use of unwritten criteria to approve merit pay plans. The OPM merit pay group believes certain factors need to be included in an agency's merit pay plan, but it has not spelled them out in official guidelines. Some of these unwritten factors include: a meaningful pay distinction between outstanding and satisfactory ratings, the existence of a salary ceiling which limits the movement of employees performing at a satisfactory or less level, and an explanation of employees' progression through the pay range. While the group says it will not disapprove a plan if an agency excludes these factors, it does work very hard with an agency to get them included. Some agencies, however, complained that OPM's informal process of communicating these points was inadequate. One agency was not aware of the factors until after its plan had been subjected to OPM review.

EVALUATION OF AGENCIES' SYSTEMS IS LACKING

OPM requires agencies to include an evaluation plan in their performance appraisal system before the system can be approved. However, in its review of agencies' implementation activities, OPM found that they did not have, as a top priority, the evaluation of performance appraisal and merit pay efforts. Many agencies were struggling just to implement by the October 1981 deadline. Also, in our discussions with OPM officials, we found that OPM is doing little to evaluate the quality of agency systems. In fact, both the performance appraisal and merit pay groups have no formal plan for evaluating agency systems. Also, these groups have done little to evaluate the experiences of the eight agencies that made payouts in 1980.

OPM has reviewed agencies' performance appraisal implementation status. While these reviews have identified some problems, they have not been detailed enough to disclose major areas of concern. For example, OPM reviewed SBA's pay-for-performance system and determined that no outstanding problems existed. However, SBA had forced the distribution of ratings, which is prohibited by OPM regulations, and had also used added performance criteria at the end of the rating period, which is prohibited under the law. (See pp. 14 to 17.) Also, SBA's merit pay employees have filed more grievances than employees in other agencies that made merit pay determinations in 1980.

CONCLUSIONS

We do not believe OPM has provided the leadership, guidelines, and assistance needed to assure quality pay-for-performance programs are implemented. OPM has taken a decentralized, nonprescriptive approach, allowing agencies to design and implement systems tailored to fit their needs. While we realize that decentralization affords flexibility, we believe that agencies should also have ample guidelines and assistance with the important aspects of any new initiative such as the merit pay program.

We believe OPM's lack of commitment and unwillingness to undertake a dynamic leadership role has raised serious doubts about the success of the merit pay program. Guidelines have been untimely, inadequate, or unclear on critical points. And perhaps most crucial, OPM has made little effort to assess the quality of systems being implemented.

OPM must take a more active role in managing the development and implementation of the merit pay program. OPM must insure that agencies are implementing quality performance appraisal systems on which equitable merit payouts can be based. It is not enough that agencies simply meet the October 1981 deadline. If OPM cannot assure the Congress that an agency's merit pay program will be implemented properly, that agency should be required to delay making merit pay determinations this October.

RECOMMENDATIONS TO THE DIRECTOR, OPM

To improve the quality of performance appraisal systems on which equitable merit payouts will be based, we recommend that the Director, OPM:

- Require all agencies to comply with OPM guidelines on defining levels of performance before a payout is made.
- More clearly define which employees are to be included in the merit pay program.

CHAPTER 3

ACTION NEEDED TO ASSURE ADEQUATE

PAY-FOR-PERFORMANCE SYSTEMS

We believe that sound performance appraisal systems are crucial to the successful implementation of merit pay in the Federal Government. By October 1981, performance appraisal systems must provide the basis upon which agencies will make merit pay decisions for as many as 152,000 Federal managers and supervisors. As this deadline nears, we are concerned about agencies' readiness to make sound merit pay decisions. Performance appraisal experts in private industry say good performance appraisal systems take 3 to 5 years to develop, with extensive pretesting and evaluation. Federal agencies, however, were given only 2 years to develop their systems and many will not have pretested or evaluated their systems by October 1.

Eight agencies chose to implement merit pay systems in October 1980. Their experiences, as well as the status of implementation in 15 large agencies scheduled to make merit payouts in October 1981, point to several problems which we believe need to be corrected:

- Four of the six agencies we visited which implemented merit pay in 1980 did not thoroughly pretest their performance appraisal and merit pay systems before making pay determinations. Many of the agencies planning to make payouts in 1981 have not conducted pretests.
- Each of the six agencies experienced difficulty with performance standard-setting. Lack of employee participation in standard-setting and the use of overly quantitative standards (with limited emphasis on qualitative measures) were typical problems.
- Higher level reviews of appraisals sometimes used other than preestablished performance criteria, resulting in downward revisions of employee ratings and a number of employee grievances.

Any new program such as merit pay will have its share of startup problems. However, unless basic problems are resolved, pay for performance may have little chance for success in the Government.

PRETESTS OFTEN ABSENT OR INADEQUATE

Although pretests of pay-for-performance systems are important, four of the six agencies we reviewed that made merit

payouts in 1980 did not thoroughly pretest their systems. Also, many of the agencies preparing to make initial payouts in 1981 have not pretested.

Pretests emphasized but not required

According to OPM, one of the most important lessons learned from the October 1980 merit payout was the importance of pretesting. OPM recommends that pretests should include both the performance appraisal and merit pay programs, be carried through to computer-simulated merit payouts, and conclude with corrections to agency systems on the basis of pretest results.

In our prior report on merit pay, 1/ we pointed out that pretesting before implementation can

- give managers the opportunity to refine appraisal skills before making pay decisions,
- help work out "bugs" which inevitably appear in a new program, and
- help reduce employee resistance to program changes.

We recommended that OPM require all agencies to pretest their systems before full implementation. Although OPM agreed with us as long ago as October 1980 that pretesting is important and has strongly encouraged its use, it has not required agencies to pretest their systems.

Limited pretesting before 1980 payouts

In the six agencies we reviewed that implemented merit pay in 1980, only OPM and the Civil Aeronautics Board conducted what we considered complete and adequate pretests of their systems. They felt that pretesting was an essential step in eliminating potential implementation problems and in assuring that a smooth-working merit pay system was developed. The Farm Credit Administration pretested only its merit pay system, the Environmental Protection Agency (EPA) pretested its system in only one region, the Commission on Civil Rights did not pretest at all, and SBA used pretest results to make personnel decisions--thereby subverting the purpose of the pretest.

1/"Federal Merit Pay: Important Concerns Need Attention," (FPCD-81-9, Mar. 3, 1981).

We recognize that pretesting is not an end in itself. The way an agency handles the problems identified by the pretest adds to its value. Although SBA identified major implementation problems, management's actions to correct these problems resulted in reduced credibility of the merit pay system. Disturbed by high ratings (over 70% of the merit pay employees were rated above average), SBA

- redefined employee performance levels, making them more subjective;
- added new performance criteria that employees were not aware of, such as after-the-fact assessments of the adequacy of standards and objectives; and
- changed ratings to achieve a bell curve (a practice expressly prohibited by OPM).

We believe these changes negatively affected the merit pay program at SBA, negating any positive benefits that could have been derived from the pretest. The MSPB survey indicated SBA's employees were more negative toward merit pay than employees in any other agency. Over 31 percent said their performance was not fairly rated, and nearly 50 percent said their appraisal experience was "not very helpful" or "did more harm than good." A total of eight employee grievances were filed as a result of this pretest.

Groups in OPM pretested the performance appraisal and merit pay system three times before making an actual merit payout. Each time a group pretested and identified problems, OPM made system refinements and tested the system again. As a result, merit pay employee attitudes toward performance appraisal and merit pay are more positive at OPM than in other agencies, and no formal grievances have been filed.

Pretests are not being
conducted Government-wide

We also reviewed the extent pretesting was being done in agencies preparing to implement in October 1981. Only seven of the 15 agencies we contacted had fully pretested their system. Seven conducted no pretests, and one has done so in only certain areas. Several of the officials interviewed said tests were not conducted because they did not have enough time before the October 1 deadline. The importance of pretests is underscored by the fact that most agencies that did so identified problems and then refined their systems.

EMPLOYEE PARTICIPATION AND THE QUALITY OF PERFORMANCE STANDARDS NEED ATTENTION

Standard-setting is a crucial phase of the performance appraisal process because it is the basis for all appraisal actions.

The Reform Act requires that, to the maximum extent possible, performance standards should permit the accurate evaluation of job performance on the basis of objective criteria. According to OPM guidelines, employees should be significantly involved in the process and care should be taken to insure that the standards are objective and valid and that they address both the quantitative and the qualitative aspects of the job. All six of the agencies we visited experienced some difficulties in setting performance standards during the first year of merit pay. These problems involved both the extent of employee participation and, in some agencies, the quality of the standards.

Employee participation linked to system acceptance

The successful implementation of a performance appraisal system must ultimately rest on employee support and acceptance. Employee participation in standard-setting is believed to be one way to gain support and acceptance, so both the Reform Act and OPM guidelines encourage employee participation in the process. Unfortunately, not all employees are being afforded that opportunity. Over one-fourth of the merit pay employees MSPB surveyed said they either played no role in developing their standards or were only allowed to comment on them after they were developed.

The data from the MSPB questionnaire indicated that employee participation in setting performance standards varied considerably from agency to agency. Participation was lowest at the Commission on Civil Rights where consultants developed the standards (34% of employees responded that they were at least "jointly" involved in the process with their supervisor) and highest at OPM (87% jointly involved in standard-setting). The questionnaire responses also indicated that employees who participated in standard-setting were more likely to believe their standards were rational and more often found the appraisal experience helpful than those who did not participate.

At SBA, for example, employees were initially allowed to participate in the development of their performance standards. Agency management subsequently developed other standards which were considered more in line with the goals of the agency, as well as new standards related to supervision, Equal Employment Opportunity goals, and merit pay systems support. These new standards were

imposed on merit pay employees without their participation. In replying to the MSPB questionnaire, SBA employees were less willing to participate in the merit pay program than employees in any other agency, and nearly 75 percent said the administration of merit pay in their agency was "poor."

Agencies had difficulties with performance standards

All six of the agencies we visited indicated standards were reviewed at the beginning of the appraisal period; however, the performance standards set during the first year illustrate the need for more effective management review. For example:

- At SBA and EPA, standards emphasized quantitative aspects of the job and paid little attention to the quality of the employee's performance or of the work product.
- At the Commission on Civil Rights, some merit pay employees did not feel their standards adequately reflected their jobs.
- At OPM, standards did not sufficiently address the complexity of the various jobs and had to be revised because of agency concern that the result could lead to inequities in the merit pay distribution.

Performance standards have been set, many for less than a year

All of the 15 agencies preparing to pay out in October 1981 that we reviewed have set performance objectives and standards for their merit pay employees, in one case as long ago as January 1980. However, as of March 1981, some agencies were still setting performance standards, thereby delaying the start of the appraisal periods for some employees. Ten of the 15 agencies will have performance appraisal periods of less than 1 year by October 1981. Although FPM suggests that 120 days be considered the minimum amount of time in which a supervisor would be able to make an objective performance appraisal of a newly promoted or reassigned employee, OPM has not set a required time limit for an adequate appraisal period. Two agencies will have performance appraisal periods as short as 90 days for some employees.

HIGHER MANAGEMENT MADE ARBITRARY CHANGES TO APPRAISALS

OPM regulations require an agency official at a higher level than the supervisor to review the performance appraisals used in determining merit pay to make sure consistent performance criteria are used to appraise employees. All six agencies we visited had

developed procedures for this higher level review; however, here too, we found problems.

At EPA and SBA, initial performance appraisals appeared to be highly inflated with most of the ratings in the top two performance categories. Problems occurred when higher level reviewers, who had not directly observed performance or had not been involved in performance planning, lowered appraisals using factors other than preestablished performance standards.

EPA supervisors rated 85 percent of the merit pay employees in the top two categories. Because of this, an ad hoc group of senior executives lowered many of the ratings after reviewing the appraisals against new criteria. According to an EPA evaluation, these management actions were taken by senior managers who had little or no firsthand knowledge of employees' actual performance and who had not been actively involved in the performance planning process.

Similar revisions to final appraisal scores occurred at SBA. As a result of management review, 71 of 680 (11%) ratings were lowered. Many of these appraisal changes were based on arbitrary and subjective criteria. For example, one employee's appraisal was lowered because his performance standards (as approved by management earlier in the appraisal period) were loosely worded and presented minimal challenge. Another employee's appraisal was lowered because his performance standards were thought to be unimaginative. Some employees' appraisals were lowered without written explanations. An agency official stated that such revisions were an attempt to achieve a forced distribution of appraisals. OPM regulations specifically prohibit such actions.

At SBA, as a result of the formal appraisal, a total of at least 28 formal and 17 informal performance appraisal grievances were filed. Thirteen of these grievances were against revisions made to ratings during the management review process. Of 18 total grievances settled to date, 15 have been resolved in favor of the employee.

CONCLUSIONS

Pretesting, standard-setting, and higher level review of performance appraisals are all crucial to the successful implementation of the merit pay program. However, the experiences of six agencies that paid out in 1980 and the status of implementation in 15 agencies that are preparing to pay out in 1981 point to serious performance appraisal problems and raise questions about agencies' readiness to make sound pay decisions based on performance.

The most serious problem was the absence of an effective pretest in most agencies implementing merit pay in 1980 and preparing for payouts in 1981. Pretesting--properly accomplished and covering the entire pay-for-performance process--can give managers and employees confidence that performance standards are reliable and also provide managers with experience in conducting appraisals, thus promoting employee acceptance and improving the link between pay and performance. Although OPM agrees that pretesting is important, it has not required agencies to pretest.

Standard-setting is the basis for all appraisal actions. Setting good quality standards is essential to a successful merit pay program in that employee participation can greatly enhance the chances for a successful, credible pay-for-performance system.

Higher level review at both the beginning and end of the appraisal process should be used to help insure consistent performance appraisals agencywide. Furthermore, all levels of management involved with reviewing performance appraisals should also be involved with reviewing performance standards early in the appraisal period to help insure consistent performance appraisals and to avoid the use of new criteria at appraisal time.

RECOMMENDATIONS TO THE DIRECTOR, OPM

To enhance the chances for successful implementation of the merit pay program, we recommend that the Director, OPM:

- Require agencies to pretest their entire pay-for-performance systems, from standard-setting to appraisal and merit payouts, before making actual payouts.
- Petition the President to grant exclusions from the October 1981 merit pay deadline to those agencies that have not pretested their entire performance appraisal and merit pay systems and those agencies that do not comply with OPM guidelines.
- Certify, after reviewing an agency's pretest, that the agency does fairly and accurately link pay to performance.
- Require agencies to insure employee participation in developing performance standards that address the most important elements of the employee's job in both qualitative and quantitative terms.

--Insure that agencies use performance standards that have been agreed to by the supervisor and employee at the beginning of the appraisal period as the basis for performance evaluations as mandated by the Reform Act. Require those managers responsible for reviewing performance appraisals to also review and approve performance standards early in the appraisal period.

--Require agencies to have performance standards in place a minimum of 120 days before making pay decisions based on those standards.

RECOMMENDATION TO THE PRESIDENT

We recommend that the President, on the basis of OPM's petition, exclude from the October 1981 mandatory merit pay implementation date those agencies that have not pretested their entire performance appraisal and merit pay systems and those agencies whose systems do not comply with OPM's guidelines and General Counsel opinion. This will enable OPM to require agencies to pretest their entire pay-for-performance systems before making actual merit payouts and to give agencies time to make their performance appraisal systems comply with OPM guidelines and the General Counsel opinion.

RECOMMENDATION TO THE CONGRESS

If the October 1981 mandatory merit pay implementation deadline is not delayed, we recommend the Congress enact an appropriation restriction in a fiscal year 1982 appropriations act. This restriction would prohibit agencies from making merit payouts beginning in October 1981 if they have not pretested their entire performance appraisal and merit pay systems or complied with OPM guidelines.

The following or similar language should be incorporated in a fiscal year 1982 appropriations act:

"No part of any appropriation contained in this or any other Act, or the funds available for expenditures by any agency, shall be used to fund an agency's merit pay program unless that agency has pretested its entire performance appraisal and merit pay system and is in compliance with OPM's merit pay program guidelines."

CHAPTER 4

MERIT PAY FORMULA RESULTS IN

INCREASED GOVERNMENT COST

Our review of the agencies that made merit payouts in October 1980 surfaced several problems with the merit pay program that we believe must be resolved before other agencies make merit pay determinations. These problems are (1) OPM's method of computing agencies' merit pay pools uses exaggerated amounts for within-grade and quality-step increases which will result in increased payroll expenditures that could total as much as \$74 million annually and (2) monies exceeding the \$50,112.50 statutory pay ceiling are being used to fund merit pay increases for employees below the ceiling.

We have issued a Decision of the Comptroller General which addresses the problems with the merit pay funding formula (see app. VI).

MERIT PAY FORMULA INCREASES PAYROLL COSTS

The Reform Act specifies that the amount available for merit pay should reflect what would have been spent for covered employees under the General Schedule pay system. However, OPM's merit pay funding formula will increase annual payroll costs over what would have otherwise been spent if merit pay employees had remained under the General Schedule.

By law, employees included in the merit pay system are assured of receiving only half of the annual comparability pay increase unless OPM raises this portion of comparability. The remainder of the comparability increase, plus an amount for within-grade and quality step increases that would have been granted if the employees had remained under the General Schedule, constitute the merit pay fund.

Using a formula developed by OPM, agencies determine the total amount of money available for merit payouts. However, this formula as currently designed will increase fiscal year 1982 payroll expenditures for merit pay employees by approximately \$58 to \$74 million ^{1/} (depending on the actual number of employees converted to merit pay) over what would have been spent had

^{1/}Based on the cost experience of the three largest agencies reviewed--which included about 85 percent of the merit pay employees in the agencies that made payouts in 1980.

the General Schedule pay system remained in place. Furthermore, these additional funds will be required in each succeeding year. Increased expenditures in the three largest agencies that made payouts in October 1980 represented approximately 23 percent of the total merit pay funds that these agencies expended.

The increase in payroll expenditures for the merit pay system is caused primarily by additional amounts in the formula for within-grade and quality step increases. A third factor, the use of "capped" money, can also increase payroll expenditures in some instances.

OPM overstated within-grade
and quality-step increases

Under the General Schedule, employees receive within-grade step increases periodically on the basis of the last promotion or date of employment. Employees in steps 1 through 3 receive a step increase each year; steps 4 through 6 every 2 years; and steps 7 through 9 every 3 years. Employees who have reached step 10 receive no further step increases.

OPM's merit pay computation table, however, assumes that all employees would have received a within-grade increase at the beginning of the year when merit payouts are initiated (normally, the first pay period in October). Consequently, many within-grade increases are included in the merit pay formula before they would have been effective under the General Schedule. Due to the earlier timing of these increases, more funds are being paid to merit pay employees than would have been spent under the General Schedule. (See app. VII.)

For purposes of the computation table, OPM set quality step increases at .4 percent of the payroll for merit pay employees. Historically, the factor was about .1 percent under the General Schedule. OPM based the .4 percent on its belief that many agencies underutilized quality-step increases and that .4 percent better represented what agencies should have been spending. While OPM believed quality-step increases should have been more widely used, the fact remains that the .4 percent overestimates what would historically have been spent under the General Schedule.

The effects of the additional funds were empirically evident in the analysis of merit payouts made by the eight agencies which initiated merit pay in 1980. At the three largest agencies we visited, representing about 1,850 of the approximately 2,200 employees paid in October 1980, payroll costs for merit pay employees were approximately \$1 million more than they would have been under the General Schedule. This increased cost added almost 1.2 percent to the average merit pay employee's pay increase. As the OPM formula is constructed, similar increased costs will be incurred every year.

OPM agrees that merit pay payroll expenditures will be larger, but attributes it to necessary costs associated with the transition from the General Schedule system. However, we disagree. The correct funds for the within-grade increase component of the merit pay formula can be ascertained by restructuring the merit pay funding formula to take into account when merit pay employees would have actually received their within-grade increases had they remained under the General Schedule. Additionally, unless OPM shows that merit pay employees would have received quality-step increases in an amount different from what they historically received, OPM should use the .1 percent of payroll figure historically spent on quality-step increases in computing this portion of the merit pay funding formula. These methods would provide funds equal to what would have otherwise been spent under the General Schedule pay system.

"Capped" money being used to compensate employees below the ceiling

Under existing legislation, any salary amount exceeding the \$50,112.50 statutory pay ceiling imposed on Federal employees cannot be legally paid. Employees at the GS-15, step 5, level and above are now limited to this ceiling. "Paper raises" beyond this point may be granted, but actual pay cannot exceed the \$50,112.50 limitation.

Although this ceiling also applies to employees under the merit pay system, the OPM merit pay formula adds amounts for employees at the ceiling to the merit pay pool as if their pay were not restricted. In other words, an amount equal to one-half of comparability plus an amount for within-grade increases and quality-step increases is added to the merit pay fund for these employees. The merit pay fund is then allocated regardless of whether the employee is at the pay ceiling (although any funds awarded to an employee at the ceiling are set aside and not actually paid out). If an employee at the ceiling is not awarded the full amount that he or she "contributed" to the fund, then the leftover balance can be awarded to employees below the ceiling.

At two of the larger agencies making payouts in 1980, employees at the \$50,112.50 ceiling contributed more to the merit pay fund than they received--which left additional money in the pay pool that was paid to employees below the salary ceiling. At OPM, for example, the average amount contributed by employees at the \$50,112.50 ceiling to the merit pay fund was \$2,924. The average amount awarded to employees at the ceiling was \$2,268--leaving an average of \$656 from each of these employees in the fund to be actually paid to other merit pay employees. At a third large agency, employees at the ceiling were awarded more than they contributed. The fact remains, however, that the merit pay system, as currently operated, allows capped funds to be

awarded through salary increases to noncapped employees. (Our analysis considered employees at the \$50,112.50 ceiling at the start of merit pay, or those that reached the ceiling with half the comparability increase.)

CONCLUSIONS

We believe the intent of the Congress was clear--to establish a pay-for-performance system for grades 13 through 15 without increasing payroll expenditures. However, unless OPM takes immediate action to correct its funding formula and insure that monies exceeding the \$50,112.50 ceiling are not paid out, the amount of funds specified for merit pay by the Reform Act will be exceeded by as much as \$74 million every year, beginning in October 1981. The October 1980 merit payout in the eight agencies has already resulted in overpayments of approximately \$1 million.

RECOMMENDATIONS TO THE DIRECTOR, OPM

The Reform Act restricts the amount available for merit pay to the amount which would have been spent under the previous pay system. Therefore, we urge that the Director, OPM:

- Revise the merit pay computation formula to insure that payroll costs under merit pay do not exceed what would have been paid had the General Schedule pay system remained in place for merit pay employees.
- Develop a 1981 merit pay computation formula for those agencies that have already made payouts to adjust for the additional funds used in 1980.
- Insure that merit pay funds attributable to employees at the \$50,112.50 statutory pay ceiling are not used to reward employees below the ceiling..

WILLIAM D. FORD, MICH., CHAIRMAN

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House of Representatives
 Committee on Post Office
 and Civil Service
 Washington, D.C. 20515

February 19, 1981

Honorable Elmer B. Staats
 Comptroller General
 General Accounting Office
 Washington, D. C. 20548

Dear Mr. Staats,

Since the passage of the Civil Service Reform Act of 1978, this Subcommittee has been concerned with the progress of Federal agencies in implementing the performance appraisal and merit pay provisions of the Act for GS-13's through -15's. As we near the October 1981 deadline for implementation, we find it necessary to assure ourselves that agencies are designing and implementing systems which will make fair and objective assessments of performance and will make sound pay determinations based on that information.

In this connection, we have tentative plans to hold oversight hearings early this year on the experiences of the eight Federal agencies that made merit pay determinations in 1980. We would like the General Accounting Office to review the performance appraisal and merit pay procedures used in these agencies to make payouts and provide a report of agency activity.

We plan to hold additional hearings during the summer to address the adequacy of planning and preparing for October 1981 merit payouts in the remaining Federal agencies. For the hearings, we would like the General Accounting Office to provide us with information on the performance appraisal and merit pay implementation as well as employee attitudes in the remaining agencies and the readiness of these agencies to make merit payouts.

Your timely assistance in regard to this matter will be greatly appreciated.

Sincerely,



Mary Rose Oakar
 Acting Chair
 Subcommittee on Compensation
 and Employee Benefits

COMPENSATION SYSTEM FOR
GENERAL SCHEDULE EMPLOYEES

Under the compensation system preceding the Reform Act, there were three ways General Schedule employees could be compensated:

- Comparability adjustments.
- Within-grade step increases.
- Quality-step increases.

COMPARABILITY ADJUSTMENTS

The Federal Salary Reform Act of 1962 established the comparability principle which states that Federal salary rates for white-collar employees under the General Schedule should be comparable with private enterprise rates for the same levels of work. This principle has been retained in subsequent legislation dealing with pay comparability.

The Federal Pay Comparability Act of 1970, in effect, transferred primary responsibility for adjusting pay scales for General Schedule employees from the Congress to the executive branch. The law established three principal groups to carry out the comparability process--the President's Pay Agent, the Federal Employee's Pay Council, and the Advisory Committee on Federal Pay.

After considering the report of the Pay Agent, which includes the findings and recommendations of the Pay Council, and the Advisory Committee report, the President must either agree to the comparability pay adjustment recommended to take effect in October or submit an alternative plan to the Congress which would go into effect unless a majority vote of either House disapproves it. If the alternative plan is disapproved, the President is required to make a comparability adjustment according to the statute's principle of comparability.

WITHIN-GRADE STEP INCREASES

Previous law (5 U.S.C. 5332) established the matrix for General Schedule salaries. Under the fiscal year 1980 matrix, grades GS-1 through GS-14 have a 30-percent pay range with 10 uniform steps, grade GS-15 has a 23-percent range with 8 steps, GS-16 has a 5-percent range with 3 steps, and GS-17 and GS-18 have a single rate. Each step is worth 3.3 percent of the minimum rate for the grade. These step increases are in addition to the general salary increases which result each year from the comparability adjustment.

Employees advance to the next step after completing 1 year in steps one through three, 2 years in steps four through six, and 3 years in steps seven through nine--provided performance is "of an acceptable level of competence." Step increases are received by 99 percent of all General Schedule employees on the date of eligibility.

QUALITY-STEP INCREASES

The Federal Salary Reform Act of 1962 also provided for the granting of additional pay step increases in recognition of exceptionally high-quality performance. This provision has been generally considered a performance award similar to the performance awards authorized under the Incentive Awards Act, differing only in the nature of the reward and the criteria. In the past, quality increases have been granted to less than 5 percent of all Federal employees each year (.1% of payroll costs).

AGENCIES REVIEWED THAT MADE MERITPAYOUTS IN OCTOBER 1980 (note a)

	Number of GS-13s through <u>15s covered</u>
Civil Aeronautics Board	221 of 248
Commission on Civil Rights	47 of 86
Environmental Protection Agency (note b)	488 of 488
Farm Credit Administration	53 of 86
Office of Personnel Management (note c)	571 of 1,261
Small Business Administration	805 of 1,136

a/We did not review the Selective Service and Metric Board because of the small number of merit pay employees involved (15 and 3, respectively).

b/These figures represent only those regional and headquarters offices that made merit payouts in October 1980. Agencywide merit payouts are not scheduled until October 1981. EPA has a total of about 3,629 grade 13s through 15s.

c/OPM has indicated that additional merit pay "management officials" may be identified for the October 1981 payout.

AGENCIES REVIEWED THAT ARE SCHEDULED TO
MAKE MERIT PAY OUTS IN OCTOBER 1981 (note a)

Agriculture (note b)

Commerce

Education (note b)

Energy (note b)

Federal Aviation Administration

General Services Administration

Health and Human Services

Housing and Urban Development

Interior (note b)

Justice (note b)

Labor

Social Security Administration

State (note b)

Transportation (note b)

Treasury (note b)

a/Merit pay employees in these 15 agencies comprise between 40 and 50 percent of the approximately 120,000 to 152,000 merit pay employees throughout the Government.

b/Pretests (from standard-setting to mock payout) have not been conducted.

MSPB SURVEY METHODOLOGY

To assess the attitudes and experiences of mid-level Federal employees in merit pay, we used data from a survey initiated and conducted by the Merit Systems Protection Board's (MSPB) Merit Systems Review and Studies Group. A major portion of the survey investigated employee attitudes and experiences with regard to the performance appraisal and merit pay systems in their agencies. The survey results provided the best available data on how the merit pay experiment was viewed by employees in the participating agencies. We were not involved in the questionnaire design.

The questionnaire was developed and pretested in the summer and fall of 1980 in consultation with employees, interest groups, and other Government agencies. A random sample of GS-13 through GS-15 employees was drawn from the June 30, 1980, edition of the Central Personnel Data File maintained by OPM. The sample included 60 individuals from each of the three grades within each of the 27 agencies or agency groups surveyed. The questionnaires were mailed in December 1980, and by February 1981, 69 percent of those that were deliverable had been returned.

The data reported from the questionnaire used in our report deals exclusively with the eight agencies making merit payouts in 1980. All GS-13 through GS-15 employees in five of the agencies were included in the sample because they had less than 60 employees in one or more of the target grades.

A standard computer program (Statistical Package for the Social Sciences) was used to analyze the questionnaire data. Because equal proportions of GS-13 through GS-15 employees were included in the original sample and the respondents were also approximately evenly distributed among these three grades, individual responses were mathematically weighted to insure that the results would more closely approximate the true proportion of GS-13 through GS-15 employees in these agencies. Confidence intervals for the responses of all merit pay eligibles ranged from + 1.1 percent to + 6.0 percent. Intervals for particular agencies were somewhat higher.

DECISION

**THE COMPTROLLER GENERAL
OF THE UNITED STATES**
WASHINGTON, D. C. 20548

FILE: B-203022

DATE: September 8, 1981

MATTER OF: Office of Personnel Management's Implementation of Merit Pay

- DIGEST:**
1. The merit pay provisions of the Civil Service Reform Act (5 U.S.C. § 5401 *et seq.*) require that the merit pay system cost no more than the pre-merit pay system. Merit pay system is only meant to redistribute funds which would otherwise have been spent on certain salary increases under pre-merit pay system. Accordingly, OPM should revise its merit pay calculations for within-grade step increase and quality step increase components of merit pay pool according to what agencies would have otherwise spent on these types of salary increases under the merit pay system.
 2. OPM should not add "capped" funds, which would have been paid to certain merit pay employees if not for the salary ceiling, to the fund to be used for merit pay awards. The ceiling imposed on salaries pursuant to certain appropriations restrictions is a limitation on the merit pay system in that funds which could not have been paid under the pre-merit pay system are not to be included in the merit pay pool.

During the course of an audit of the implementation by the Office of Personnel Management (OPM) of the Merit Pay System under the Civil Service Reform Act (CSRA), we have found that the method used by OPM to calculate amounts available for merit pay payouts by agencies does not conform to the requirements of the Act.

Under provisions contained in 5 U.S.C. § 5402(b)(4), OPM is required to determine the amount of funds available for the merit pay program of each Executive agency and department prior to the beginning of each fiscal year. OPM construes this provision of the merit pay statute differently than does this Office. These differences center upon the extent of the discretion granted OPM by this statute to calculate the amount available to each agency and department for merit pay. This statute reads as follow:

"(4) The funds available for the purpose of this subsection to the head of any agency for any fiscal year shall be determined before the beginning of the fiscal year by the Office [of Personnel Management] on the basis of the amount estimated by the Office to be necessary to reflect--

"(A) within-step increases and quality step increases which would have been paid under subchapter III [General

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Schedule Pay Rates] of chapter 53 [Pay Rates and Systems] of this title during the fiscal year to the employees of the agency covered by the merit pay system if the employees were not so covered; and

"(B) adjustments under section 5305 [annual pay reports and adjustments] of this title which would have been paid under such subchapter during the fiscal year to such employees if the employees were not so covered, less an amount reflecting the adjustment under subsection (c)(1) of this section in rates of basic pay payable to the employees for the fiscal year." [Subsection (c)(1) allows OPM to reduce annual cost of living increases for merit pay participants by as much as 50 percent.] (Emphasis added.) 5 U.S.C. § 5402(b)(4).

It is OPM's position, in essence, that the statutory authorization to OPM to estimate the amount necessary to reflect salary increases which would have been received by merit pay participants under the pre-merit pay system was intentionally drafted to give OPM the broadest possible discretion in determining the merit pay pool. OPM also relies on its statutory responsibilities under the Civil Service Reform Act as a whole to devise an equitable merit pay system which will be accepted as such by merit pay participants. Thus, OPM believes it is authorized to add funds to the merit pay pool in excess of what actually would have been spent had merit pay not been implemented, to satisfy certain objectives such as ensuring that no employee be penalized due to the implementation of merit pay and ensuring that the average annual salary rate of all employees subject to merit pay be equivalent to what their average annual salary rate would have been under the pre-merit pay system.

Our Office's position, on the other hand, is that the quoted provision limits OPM to estimates of the amounts which would have been paid for within-grade, quality step, and comparability increases if merit pay employees were still under the old system.^{1/} Further, this

^{1/} In this regard this Office does not object to regulations promulgated by OPM at 5 CFR 540.103(d) which permit agencies to expend an amount no less than 95 percent and no greater than 105 percent of the merit pay figure provided annually by OPM. OPM's formula is based on estimates of events which would not be susceptible to precise determination before the fact even in the absence of the merit pay situation. In view of the imprecise nature of the estimates, we believe that OPM has properly incorporated a degree of flexibility into the system.

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provision's legislative history convincingly demonstrates that Congress intended for the merit pay system to cost no more than the amount expended under the pre-merit pay system. It was the intent of the Congress that the implementation of the merit pay system would only redistribute an amount essentially equal to the amount expended under the pre-merit pay system.

This intent is clearly expressed in statements made by President Carter, by the Chairman and Deputy Executive Director of the Civil Service Commission (currently OPM), and by statements contained in the Senate and House Committee Reports. President Carter, in a message to the Congress, stated that the merit pay system " * * * would not increase payroll costs * * * ." (Weekly Compilation of Presidential Documents, March 2, 1978). This position was reiterated by The Honorable Alan K. Campbell, Chairman, U.S. Civil Service Commission when he stated: "The net effect of these changes [the merit pay system] is that employees as a group will receive neither more nor less than they presently do, but those individuals performing in a superior fashion will receive higher salary increases." (Civil Service Reform Act of 1978 and Reorganization Plan No. 2 of 1978: Hearings on S. 2640, S. 2707, and S. 2830 before the Committee on Governmental Affairs United States Senate, 95th Cong., 2d Sess. 36 (1978)). Also, Mr. George J. McQuoid, Deputy Executive Director, U.S. Civil Service Commission, in responding to questions from the staff of the Senate Committee on Governmental Affairs in the above cited hearings stated:

"There will be no impact, either plus or minus, on overall payroll and benefit costs as a result of the introduction of the merit pay program. Under the program, funds which, under the present system, would be expended automatically would be redistributed based upon meritorious performance rather than time in grade."

Moreover, in a section-by-section analysis of S. 2640, The Civil Service Reform Act, by the Senate Governmental Affairs Committee, it is stated:

"The merit pay system would not require additional expenditure of money. The money saved from not awarding full across-the-board comparability increases and automatic step increases would be used to reward those employees who deserve pay raises or bonuses." S. Rep. No. 95-969, 95th Cong., 2d Sess. 88 (1978).

Finally, both the Senate and House Committee Reports contain cost estimates from the Congressional Budget Office stating that the implementation of the merit pay system would have no effect on the total amount of funds expended for personnel compensation. S. Rep. No. 95-969,

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95th Cong., 2d Sess. 123 (1978); H.R. Rep. No. 95-1403, 95th Cong., 2d Sess. 94 (1978).

The fundamental issue, as we see it, centers around proper determination of the size of the "appropriation" Congress has made available for merit pay purposes. In our opinion, the terms of § 5402(b)(4), quoted above, coupled with the completely consistent legislative history, clearly demonstrate that the Act was only meant to redistribute funds and not to provide additional funds for salary increases. OPM's development of the merit pay formula must comply with this restriction. In our view, it is not permissible under the CSRA for OPM to calculate funds available for agency merit pay programs which would result in more money being expended under the merit pay system than would have been spent under the pre-merit pay system. Calculations by our audit staff demonstrate, however, that the amounts allowed by OPM's formula for pre-merit pay within-grade and quality step increases overstates by \$58 to \$74 million dollars the amounts which would have been paid to merit pay employees if they were still under the previous system. Furthermore, OPM's formula includes amounts for within-grade, quality step, and comparability increases which would be due merit pay employees who are at or above the statutory pay cap of \$50,112.50 if the cap did not exist or were lifted. This has the potential of permitting these funds, none of which would have been spent under the pre-merit pay system, to be used for merit pay awards to employees whose salaries are not limited by the pay cap.

Our analysis of how OPM's computation of these three facets of the merit pay formula will result in additional money being spent on merit pay is as follows:

Within-grade Step Increases

When determining the within-grade step increase component of merit pay, OPM assumes that each employee eligible for merit pay would have received a within-grade step increase under the prior program on October 1, the beginning of the fiscal year. By computing the within-grade increase component of the merit pay pool as if it were due at the beginning of the fiscal year, OPM is establishing a formula which overstates the amount of money which would have been expended on within-grade increases but for merit pay. This is because eligible employees under the pre-merit pay system would have received within-grade increases on their particular anniversary dates, which dates fall throughout the fiscal year. OPM believes that this is necessary because only by using this formula can it assure that the group of employees who would have received within-grade increases during the period October 5, 1981 to April 5, 1982, if not for the implementation

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of merit pay will not be penalized. OPM also maintains that use of the October 1 date is necessary for it to ensure that the average annual salary rate of all employees subject to merit pay will be equivalent to what the average annual salary rates of these employees would have been under the pre-merit pay system.

In our opinion, the computing of the within-grade increase component of the merit pay pool in this manner does not conform to the mandates of the CSRA. To ensure compliance with the CSRA, this component of the formula should reflect as precisely as possible what otherwise would have been actually spent on within-grade increases. Thus, OPM should compute the percentage agencies would have actually allocated from their payrolls for the awarding of within-grade increases but for merit pay in a given year and this figure should be used as part of the determination of the funds available for merit pay increases. While OPM's method of calculating within-grade increases apparently will assure that the average annual salary rate of employees under merit pay will be equivalent to what it would have been under the pre-merit pay system, this is not required by the CSRA. Similarly, the CSRA does not authorize OPM to adjust the merit pay formula to assure that employees who would have been due within-grade increases during the first half of fiscal 1982 will receive under merit pay what they would have otherwise received under the pre-merit pay system. Moreover, this seems contrary to the CSRA's basic concept of rewarding meritorious performance rather than longevity of service.

Quality Step Increases

When calculating the quality step increase component of the merit pay pool, OPM includes what it believes agencies should have spent on this type of salary increase in the past rather than the amount agencies have historically spent. It is true that the CSRA does not mandate that in calculating the quality step increase or within-grade increase component of the merit pay pool, OPM compute these components to reflect what agencies have historically spent on these two types of salary increases. Instead, the Act only requires OPM to estimate what would have been paid to employees during the fiscal year if they were not covered by merit pay. This can most logically, in our view, be achieved by referring to historical data. However, there may be other ways to satisfy this requirement and it is in OPM's discretion to determine the best possible method to meet this requirement for the various components of the pool. Thus, although agencies have historically only spent .1 percent of their payrolls on quality step increases, OPM would be authorized to use the .4 percent of payroll costs for this component it is proposing to use if OPM can show that a change in historical practice would have resulted in .4 percent of payroll costs being paid as

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quality step increases in fiscal year 1982. However, if agencies will continue to spend only .1 percent of their total payroll costs on quality step increases for non-merit pay employees in fiscal year 1982, in our view, OPM in computing this portion of the pool should only use .1 percent of total payroll costs even if OPM maintains that this will effectively result in the continued underutilization of quality step increases. In other words, unless OPM takes positive steps to assure that non-merit pay quality step increases total .4 percent of salaries Government-wide, we can see no justification for using such a percentage for merit pay pool purposes.

Increments Above the Statutory Pay Ceiling

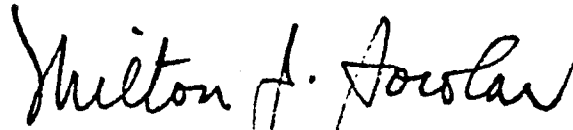
OPM includes, as part of its merit pay pool computations, amounts for within-grade step increases, quality step increases, and comparability increases which would have been paid to employees under the pre-merit pay system if it were not for the statutory cap imposed on salaries, currently fixed at \$50,112.50. OPM's procedures require that employees whose salaries exceed the cap receive accounting or "paper" increases in order that their proper pay rate will be established if the cap is ever lifted. This Office agrees that these employees must receive "paper" increases. We do not believe, however, these increases may be included in the merit pay pool if the possibility exists that these capped funds might be distributed to employees eligible for merit pay who have not reached this ceiling. A distribution of this sort will result in additional funds in the merit pay pool because these funds would not have been expended under the pre-merit pay system, given the continued existence of the pay cap. In our view, this is not permitted by the CSRA. In this regard, we would not object, in principle, to the use of "paper" salary increases which would otherwise be due capped employees for purposes of calculating how much money would be in the merit pay pool for capped and non-capped employees if the cap did not exist. However, we can see no justification for distribution to non-capped merit pay employees of any of these "paper" increases because none of these funds would be payable under the pre-merit pay system.

Conclusion

As indicated above, our audit staff has determined that the above-described OPM calculations of the various components of merit pay will make available to all executive agencies, collectively, approximately \$58 - \$74 million dollars more every year for merit pay expenditures than would have been expended under the pre-merit pay system. In our opinion, the computation of the merit pay pool in a

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manner which leads to this result is contrary to the language and intent of the CSRA. Accordingly, OPM should take immediate action to revise its merit pay implementation plan to bring it into compliance with this restriction.



Acting Comptroller General
of the United States

EXAMPLES DESCRIBING ADDITIONAL
SALARY INCREASES THAT OCCUR BECAUSE OF
OPM'S METHOD FOR COMPUTING THE MERIT PAY FUND

The following example, illustrated by the table on page 15, shows how OPM's computational method increases the within-grade portion of payroll costs. The table reflects the payroll expenditures, in relation to the within-grade portion of salary increases, for the same employee under both the General Schedule and merit pay system. This example makes the following assumptions:

1. The base salary entering merit pay is \$40,000 per year.
2. The employee is due a within-grade increase worth \$1,000 halfway through the year.
3. The employee would receive the full amount of his/her within-grade increase under merit pay.

The table shows that the payroll cost under the merit pay system is larger than under the General Schedule because the merit pay employee receives the full amount of the within-grade increase at the beginning of the year while the General Schedule increase is awarded halfway through the year.

Under merit pay, the amount paid an employee for the full year becomes the salary base. Under the General Schedule, when an employee is awarded the within-grade increase halfway through the year, the base salary increases by the full amount of the within-grade--although the payroll cost will increase by only one-half this amount. Consequently, the base salaries in the second and third years are the same under both systems, even though the merit pay employee actually receives more than the General Schedule employee.

This example is hypothetical. The \$1,000 increase paid under the merit pay system should be viewed as the contribution, in relation to the within-grade increase for the employee, to the merit pay pool. If this merit pool is reduced by one-half in the first year and allowed to remain at \$1,000 per year in the subsequent years, the payroll costs will be identical under both systems.

	General Schedule <u>system</u>	Merit pay <u>system</u>
Starting base salary	\$40,000	\$40,000
Within-grade or merit pay increase paid	+ 500	+ 1,000
Payroll cost in first year (actual)	<u>40,500</u>	<u>41,000</u>
Base salary in year 2 (obligated)	\$41,000	\$41,000
Within-grade or merit pay increase paid	+ 500	+ 1,000
Payroll cost in second year (actual)	<u>41,500</u>	<u>42,000</u>
Base salary in year 3 (obligated)	\$42,000	\$42,000

The second example simulates the salary increase history of an employee under merit pay and what the same employee's raises would have looked like under the General Schedule system. To simplify the example, only raises attributable to step increases (or that part of the merit pay pool related to step increases) are used in the presentation. As in the first example, the employee's General Schedule anniversary date is set at April 1, or at the midpoint of the fiscal year, and the amount of the step increase for the example is set at \$1,000. Also for simplicity, it is assumed that the General Schedule employee is a step one employee and would receive a within-grade step increase every April 1.

During the first year under merit pay, an employee begins receiving his/her step increase on October 1 and receives a total of the entire \$1,000 during fiscal year 1981. Under the General Schedule system, the employee has the step increase added to his/her base pay halfway through the year and collects a total of \$500 in fiscal year 1981. In the next year, under both merit pay and the General Schedule system, the employee receives \$1,000 attributable to his/her fiscal year 1981 step increase plus an amount related to the fiscal year 1982 step increase. Again, this new increase is added to the employee's base salary and is paid under merit pay starting in October, but not under the General Schedule until 6 months later. In fiscal year 1982 then, the employee under merit pay receives \$2,000 in raises above his/her starting base salary; the General Schedule employee receives \$1,500. This pattern continues throughout successive years with the amount of the yearly overpayment to the merit pay employee equal to that portion of the yearly step increase paid prior to the employee's original anniversary date each year.

TIMING OF MERIT PAY AND GENERAL SCHEDULE STEP INCREASES FOR AN EMPLOYEE WHOSE ANNIVERSARY FALLS ON 4/1/81. A FIGURE OF \$1,000 IS USED AS THE STEP INCREASE AMOUNT, AND IT IS ASSUMED THAT THE EMPLOYEE RECEIVES A STEP INCREASE EVERY YEAR TO SIMPLIFY THE EXAMPLE.

				FY 81	FY 82	FY 83	FY 84	TOTAL PAYOUT FY 81	MP-GS DIFFERENCE
								MP 1000 GS 500	500
								MP 2000 GS 1500	500
								MP 3000 GS 2500	500
								MP 4000 GS 3500	500
LEGEND: - - - - Step increase \$ based on FY 81 step Step increase \$ based on FY 82 step - . . - Step increase \$ based on FY 83 step Step increase \$ based on FY 84 step								FY 81-84 TOTAL MP 10,000 GS 8,000	2000



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